Supreme Court, U. S.
FILED
APR 4 1977
MICHAEL RODAK, JR., CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM 1976

No. 76-1359

BANKERS TRUST COMPANY,

Petitioner,

vs.

SAMUEL MALLIS and FRANKLYN KUPFERMAN,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

JACK H. WEINER
Counsel for Petitioner
1775 Broadway
New York, New York 10019

Of Counsel:
CHARLES LEEDS

March 31, 1977

TABLE OF CONTENTS

	PAGE
Opinions Below	1
Jurisdiction	2
Questions Presented	2
Statutes Involved	2
Statement of the Case	4
(a) The Facts	4
(b) Judicial Proceedings	5
1. The Decision of the State Court	5
2. The District Court Decision	6
3. The Court of Appeals Decision	7
REASONS FOR GRANTING THE WRIT	7
In holding that a pledge of stock to a commercial bank and its return to the debtor upon the repayment of the indebtedness as required under the Uniform Commercial Code subjects the bank to a lawsuit under Section 10b and Rule 10b-5 of the Securities Exchange Act, the decision of the Second Circuit in this case conflicts with the recent decision by the Court of Appeals for the Firth Circuit in *McClure* v. *First National Bank of Lubbock, Texas,* 497 F.2d 490, is contrary to the principles enunciated by this court in *Blue Chip Stamps* v. *Manor Drug Stores,* 421 U.S. 723 (1975), and raises an issue of public importance	8
Conclusion	14

PAGE

APPENDIX:

Opinion of the Court of Appeals A1

Judgment of the Court of Appeals—United States Court of Appeals for the Second Circuit A13

Decision of the District Court A15

Addendum to Memorandum Opinion of Pollack, D.J. Dated October 2, 1975 ..... A25

Decision—Opinion of New York Supreme Court A27

TABLE OF AUTHORITIES

Cases:

American Bank and Trust Company v. *Lichtenstein*, 45 A.D.2d 790, 369 N.Y.S.2d 155(1st Dept. 1975) 13

Blue Chip Stamps v. *Manor Drug Stores*, 421 U.S. 723 (1975) 8

Brodheim v. *Chase Manhattan Bank*, 75 Misc. 2d 394, 347 N.Y.S.2d 394 (Sup. Ct. N.Y. 1973) 13

Goodman v. *Kennedy*, Security Law Reporter Section 95,829 13

Grace v. *Sterling Grace & Co.*, 30 A.D.2d 61, 289 N.Y.S.2d 632 (1st Dept. 1968) 13

McClure v. *First National Bank of Lubbock, Texas*, 497 F.2d 490 (CA 5, 1974), cert. denied, 420 U.S. 930 .....7, 8, 9, 10

Piper v. *Chris-Craft Industries, Inc.*, 45 U.S.L.W. 4192 10

Santa Fe Industries, Inc. v. *Green* (—— U.S. ——), decided March 23, 1977 .....10, 11, 12

PAGE

SEC v. *Guild Films Co.*, 279 F.2d 485 (CA 2), cert. denied, 364 U.S. 819 (1960) 7, 11, 12, 13

Smith v. *Security National Bank*, 175 N.Y.L.J., p. 7, col. 1 13

United Housing Foundation v. *Foreman*, 421 U.S. 837 (1975) 10

United States v. *Gentile*, 530 F.2d 461 (CA 2), cert. denied, —— U.S. —— 7, 12

STATUTES AND RULES:

Securities Exchange Act of 1934, 15 U.S.C. § 78, 48 Stat. 881:

Section 3, 15 U.S.C. 78c(a) 2, 3

Section 10, 15 U.S.C. 78j 3

Section 10(b), 15 U.S.C. 78j(b) 6, 8, 9

Section 28(a), 15 U.S.C. Section 78bb 13

Rule 10b-5, 17 CFR § 240.10b-5 .....3, 6, 8, 9, 10, 13

New York Uniform Commercial Code:

9-207 10

9-303 10

9-506 ..... 5, 10

Article 9 10

Other Authorities:

1 Loss, Securities Regulations (2d ed., 1961) 11, 13, 14

IN THE

Supreme Court of the United States

OCTOBER TERM 1976

No. .....

BANKERS TRUST COMPANY,

Petitioner,

vs.

SAMUEL MALLIS and FRANKLYN KUPFERMAN,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioner Bankers Trust Company (hereinafter "Bankers") respectfully prays that a writ of certiorari issue to reverse the opinion and judgment of the United States Court of Appeals for the Second Circuit entered on January 3, 1977 that reversed an order of the United States District Court for the Southern District of New York dismissing the complaint for failure to state a cause of action under the anti-fraud provisions of the Securities and Exchange Act.

Opinions Below

The opinion of the Court of Appeals (A. 1-12)[1] is not as yet officially reported but is unofficially reported at CCH Fed. Securities Law Reporter at paragraph 95,823. The

[1] The numbers in parentheses ( ) prefixed by the letter "A" refer to pages of the appendix.

opinion of the District Court (A. 15-26) is reported at 407 F.Supp. 7. The memorandum opinion of the trial court, Supreme Court, New York County (A. 27-29) is not officially reported.

Jurisdiction

The judgment of the Court of Appeals was entered on January 3, 1977 (A. 13-14). The jurisdiction of this court is invoked under 28 USC § 1254(1).

Questions Presented

1. Whether a commercial bank, which had received a pledge of stock as collateral for a loan and subsequently returned the stock to the debtor upon the repayment of the loan, is subject to an action for fraud under the Securities Exchange Act on the ground that the release of the pledge constituted a sale of securities within the meaning of the Act.

2. Whether the requirement of § 10b and Rule 10b-5 that a fraud to be actionable under the Securities Exchange Act be committed "in connection with the purchase or sale of any security" is satisfied where the alleged "sale" is the release of collateral by a commercial bank of pledged stock upon repayment of its loans, and the alleged "purchase" is the subsequent pledge of the shares by a third-party.

Statutes Involved

Section 3 of the Securities Exchange Act of 1934, 15 USC § 78c(a), as amended provides in relevant part:

• • •

"(13) The terms 'buy' and 'purchase' each include any contract to buy, purchase, or otherwise acquire.

(14) The terms 'sale' and 'sell' each include any contract to sell or otherwise dispose of."

• • •

Section 10 of the Securities Exchange Act of 1934, 15 USC § 78j, 48 Stat. 891, as amended, provides in relevant part:

"It shall be unlawful for any person, directly or indirectly by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . .

• • •

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Rule 10b-5, 17 CFR (Code of Federal Regulations) § 240.10b-5 provides in relevant part:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange,

• • •

(2) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security."

Statement of the Case

(a) The Facts

The facts of this case are well set forth in the opinions of the District Court (A. 15-26) and the Court of Appeals (A. 1-12) and in the opinion of Mr. Justice Nadel for the Supreme Court of the State of New York (A. 27-29). Therefore, only a short statement of facts is here necessary.

Bankers is a commercial bank. In August, 1970, Kates who is not a party to this action, applied to Bankers for a $50,000 loan (A. 17). As collateral, he pledged 40,384 shares of Equity National Industries stock to Bankers. This stock bore a legend which declared the stock subject to an Escrow Agreement and restricted transfer in accordance with the terms of the agreement. At the time the stock was pledged to Bankers, Bankers received an opinion letter from counsel that the stock would become eligible for public sale within six months. At the time of the loan, Bankers expected the loan to be repaid by Kates and the collateral returned. By March 3, 1972, the loan had been reduced to $45,000 (A. 4).

In February-March, 1972, Kates had made an agreement with Arnold and Fowler to sell to them the shares which were being held by Bankers as collateral for the outstanding indebtedness (A. 3, 17). Arnold and Fowler persuaded the plaintiffs herein, Mallis and Kupferman, to loan to Arnold and Fowler $156,000 to be borrowed from Franklin National Bank. As part of that transaction, Arnold and Fowler agreed that Mallis and Kupferman would have as security for their loan a pledge of the stock to be purchased by Arnold and Fowler from Kates. Mallis and Kupferman were to receive a profit of $50,000 on this loan within one (1) month (A. 16-17), a fact which Bankers did not then know.

Bankers was informed by Kates that Kates had obtained a purchaser for the Equity National shares and that Kates

intended to redeem his stock. A closing was held on March 3, 1972 attended by Arnold and Fowler, Kates, a representative of Franklin and Bankers' attorney (A. 4). Banker's attorney "could not and did not know of [Mallis] existence prior to the closing, which [Mallis] did not attend" (A. 29). Franklin's representative delivered three checks totalling $156,000 to Kates. Kates endorsed one of the checks in the amount of $45,000 to Bankers as a repayment of his loan made in 1970. In accordance with Sec. 9-506 of the New York Uniform Commercial Code, Bankers released and returned the stock to the original pledgor Kates. Kates sold the stock to Arnold and Fowler, who then pledged the stock to Mallis and Kupferman.

(b) Judicial Proceedings

Subsequent to this transaction, Mallis instituted lawsuits against Bankers in both State and Federal Courts, and Kupferman joined him in the Federal Court.

1. The Decision of the State Court

On December 11, 1972, Mallis instituted an action against Bankers as well as other defendants in the State Court charging Bankers with both fraud and negligence in permitting "escrowed stock" to be delivered to the possession of Kates thereby allegedly aiding and abetting a fraudulent transaction (A. 28). In dismissing the complaint, the court ruled (A. 29):

> "The leading case on where there is a duty to speak is Amend v. Hurley, 293 N.Y. 587, which holds that barring a fiduciary or confidential relationship there is no duty to speak. Plaintiff had absolutely no relationship with defendants London, Bankers Trust or Equity National. He was not even a purchaser of the shares, according to his letter arrangement with Arnold. No matter what he chooses to call his participation in this 'investment', the Equity shares are

called 'collateral' and he is guaranteed *repayment* out of another stock transaction.

The 'fraudulent concealment' he alleges against these defendants must fall on the basis of plaintiff's own exhibits in opposition to these motions. The legend showing a restriction on the sale or hypothecation of the shares appears on the face and back of both stock certificates. The court is unable to determine when or how plaintiff could or should have been informed by these defendants, who could not and did not know of his existence prior to the closing which he did not attend."

An order of dismissal was entered and no appeal was taken.

2. The District Court Decision

In February, 1975, Mallis and Kupferman instituted this action under Section 10b and Rule 10b-5 of the Securities Exchange Act alleging that Bankers had violated the Act by transferring the securities to the plaintiff—apparently through Kates paying off the loan and selling the securities to Arnold and Fowler, who then pledged the securities to plaintiff—in order to recover $45,000. On motion to dismiss, the court dismissed the claim against Bankers for failure to state a claim upon which relief can be granted and for lack of jurisdiction over the subject matter of the controversy (A. 24). The court reasoned that the claim was barred to (A. 21):

> "plaintiffs who were not purchasers within the requirement of the *Birnbaum* doctrine. *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952), as adopted in *Blue Chip Stamps* v. *Manor Drug Stores*, 43 U.S.L.W. 4707 (June 9, 1975), —— U.S. —— (1975). The mere acceptance of a stock pledge as collateral in a privately negotiated transaction between borrower and lender does not of itself bring a transaction within

> the scope of the federal securities laws. See, e.g. *McClure* v. *First National Bank of Lubbock, Texas*, 497 F.2d 490 (5th Cir. 1974), cert. denied, 43 U.S.L.W. 3449 (1975); *Rosen* v. *Dick* (1974-75), CCH Fed. Sec. L.Rep. 94,786 (S.D.N.Y. Sept. 3, 1974)."

3. The Court of Appeals Decision

On appeal, the Court of Appeals for the Second Circuit reversed and held that "a pledge constitutes a 'contract to sell or otherwise dispose of' a security within the meaning of Section 3(14) of the 1934 Act" (A. 12). The Court expressly rejected the rationale of the United States Court of Appeals for the Fifth Circuit in *McClure* v. *First National Bank of Lubbock, Texas*, 497 F.2d 490 (CA 5, 1974) cert. denied 420 U.S. 930 and relied on its earlier decisions in *SEC* v. *Guild Films Co.*, 279 F.2d 485 (CA 2) cert. denied, 364 U.S. 819 (1960) and *United States* v. *Gentile*, 530 F.2d 461 (CA 2) cert. denied —— U.S. —— (A. 9-10). In *Gentile* supra, the Second Circuit stated "To the extent that McClure . . . suggests a contrary conclusion, we disagree with it." (530 F.2d at 467) The Court held that Mallis and Kupferman "were purchasers by virtue of their acceptance of the pledge by Arnold and Fowler; and Bankers Trust was a seller by virtue of its release of the Kateses' pledge" (A. 12).

REASONS FOR GRANTING THE WRIT

In holding that a pledge of stock to a commercial bank and its return to the debtor upon the repayment of the indebtedness as required under the Uniform Commerical Code subjects the bank to a lawsuit under Section 10b and Rule 10b-5 of the Securities Exchange Act, the decision of the Second Circuit in this case conflicts with the recent decision by the Court of Appeals for the Fifth Circuit in *McClure* v. *First National Bank of Lubbock, Texas*, 497 F.2d 490, is contrary to the principles enunciated by this court in *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975) and raises an issue of public importance.

To fall within the scope of Section 10b of the Securities Exchange Act and Rule 10b-5, the fraud alleged by the plaintiff must be "in connection with the purchase or sale of any security." (15 USC § 78j(b)). This court has held that only a purchaser or seller of a security may maintain an action for damages under Section 10b of the Securities Exchange Act and Rule 10b-5. *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975). In this case, the pledge of the stock to Bankers was in August, 1970. The release of the stock to the pledgor upon the repayment of the loan was in March, 1972. Certainly the making of a pledge in 1970 antedating the return of the securities by two years had no nexus with the alleged fraudulent transaction between Mallis, Fowler and Arnold. All that is involved in this case was the release of the pledge which was in no sense a "sale" and which cannot be relied upon to fulfill the requirements of the Act to create standing.

Contrary to the court below which held that the bank becomes a "seller" of stock when it returned the stock to the pledgor—the return of the stock to the pledgor, upon repayment of the indebtedness, does not bring the transaction within the purchase or sale requirements of Section 10b and Rule 10b-5. *McClure* v. *First National Bank of Lubbock, Texas*, 497 F.2d 490 (CA 5, 1974) cert. denied 420 U.S. 930 (1975). In that case, the plaintiff sued a bank and its loan officer on a securities fraud theory in connection with a stock transaction which arose when, as part of a loan, the bank required plaintiff to pledge her stock as collateral. Thereafter, the bank foreclosed on the loan and liquidated the assets of the corporation rendering plaintiff's stock worthless.

The District Court dismissed the complaint on the grounds of lack of subject matter jurisdiction. The Court of Appeals affirmed the lower court's ruling that the transaction did not fall within the federal securities laws stating (497 F.2d at 495):

> "A commercial bank in accepting a pledge of stock as additional consideration for the extension of an overdue commercial loan does not necessarily affect the securities industry. A commercial bank's business is lending money not trading in securities. Cf. *Bronner* v. *Goldman*, 361 F.2d 759 (1st Cir.), cert. denied, 385 U.S. 933, 87 S.Ct. 295, 17 L.Ed.2d 214 (1966) (factor selling pledged stock not a 'broker' or 'dealer'). If the bank sells stock pledged as loan collateral, it might then be subjected to liability in connection with the sale if it does not meet the requirements of the anti-fraud provisions of the securities acts, but mere acceptance of a stock pledge as collateral in a privately negotiated transaction between borrower and lender does not, of itself, bring within the scope of the federal securities acts a transaction otherwise outside their purview. See 1 L.Loss, Securities Regulation 649 (2d ed. 1961)."

This rationale of the Fifth Circuit was rejected by the Second Circuit in this case.

We submit that contrary to the Second Circuit, the Fifth Circuit correctly recognized that the pledge of stock as col-

lateral for a loan did not bring the transaction within the securities laws.

State law very carefully regulates the creation of a security interest in stock in Article 9 of the Uniform Commercial Code. Uniform Commercial Code Sec. 9-305 provides for the perfection of security interest in stock without the need for filing.

Uniform Commercial Code Sec. 9-207 sets forth the rights and duties of both the debtor and the secured party, when the collateral is in a secured party's possession, including the standard of care to be followed in the preservation of the collateral and the duties to expend reasonable care in the preservation of the rights of the debtor against all other parties. Part 5 of Article 9 sets forth the rights and duties of the secured party on default, including the debtor's rights under Uniform Commercial Code Sec. 9-506 to redeem the collateral by tendering the full amount of their obligations secured by the collateral.

If Congress in enacting the securities laws had intended all transactions involving the pledge of stock to come within the Act and not be governed by state law, it would have said so. The mere fact that securities are involved in the transaction does not automatically bring the transaction within the standing requirements of Section 10b and Rule 10b-5 and permit the action to be brought in Federal Court. See *United Housing Foundation* v. *Foreman*, 421 U.S. 837, 849 (1975) footnote 14, where this Court reversed the Second Circuit's expanded and "literal approach" to the Act by noting the Fifth Circuit's decision in *McClure*. Certainly Congress did not intend to federalize the substantive law involving the pledge of stock as collateral merely because the transaction involved securities where, as here, " 'the cause of action was one traditionally relegated to state law. . . .' " See *Piper* v. *Chris-Craft Industries, Inc.*, 45 U.S.L.W. at 4192 quoting *Cort* v. *Ash*, 422 U.S. at 78, *Santa Fe Industries, Inc.* v. *Green*

(—— U.S. ——), decided March 23, 1977. In enacting the Securities Exchange Act of 1934, Congress stated that its purpose was to provide for the regulation of "securities exchanges and over-the-counter markets" operating in interstate and foreign commerce and through the mails to prevent inequitable and unfair practices on such exchange. 15 U.S.C. § 78b, 48 Stat. 881 as amended. Congress did not intend to include ordinary commercial transactions involving stock under the umbrella of the act, especially as here where Congress did not expressly provide a private cause of action for violations of Section 10b. *Sante Fe Industries* v. *Green*, —— U.S.L.W. ——, supra.

As noted in 1 Loss, Securities Regulations (2d ed. 1961) 645 at Footnote 13:

> "The Act as introduced and as passed by the Senate expressly exempted sales 'by or for the account of a pledge holder or mortgagee selling or offering for sale or delivery in the ordinary course of business and not for the purpose of avoiding the provisions of this Act, to liquidate a bona fide debt, a security pledged in good faith as collateral for such a debt.' H.R. 4314 and S.875, 73d Cong., 1st Sess. (1933) 12(b)."

Loss noted that "the elimination of this section" in the final bill did not seem too significant, because in many instances the exemption in the original bills for isolated transactions by non-dealers 12(c), which was narrower than the first clause of 4(1) as adopted, "would not have extended to liquidating transactions by a pledgee." *Ibid.*

Similarly the Commission itself did not consider a pledge of collateral to be a sale until after the decision of the Second Circuit in *SEC* v. *Guild Films*.

Ignoring the legislative history and the Commission's earlier interpretation, the Second Circuit in this case erroneously held that the return of pledged stock to the pledgor was a sale of stock relying on its earlier decisions

in *Gentile* and *Guild*. In *U.S.* v. *Gentile*, 530 F.2d 461, 467 (CA 2, 1976) the Second Circuit held that the pledge of fraudulent securities to borrow monies was a sale by the fact that the Act was intended "to protect defrauded lenders just as much as [it was intended to protect] defrauded buyers." In *SEC* v. *Guild Films*, 279 F.2d 485 (CA 2, 1960) *cert. denied sub nom. Santa Monica Bank* v. *SEC*, 364 U.S. 819, the Court said that the bank became an underwriter when it liquidated the collateral as soon as it was received. Neither *Gentile* nor *Guild* involves, as this case does, an ordinary run of the mill pledge of securities to secure a loan which the debtor had contracted to repay and was expected to be repaid and part of which was repaid by the debtor. In those cases, the pledge of stock was not bona fide, but was merely intended as a means to distribute stock. If *Guild* and *Gentile* stand for the proposition that a pledgee's foreclosure sale may in some circumstances satisfy the requirements of Sec. 10b and Rule 10b-5, then even so, those cases do not establish the propositions advanced by the Second Circuit in this case that the mere release of a pledge upon repayment of a debt constitutes a "sale" when none of the indicia of a sale transaction are present.

The importance of this question is plainly demonstrated by the fact that commercial banks regularly receive the pledge of stock as security for loans as a daily occurrence. Securities pledged to banks throughout the United States run into the billions of dollars. Each of these loans and pledges should continue to be governed by state law.

As noted in *Santa Fe Industries* v. *Green, supra*, the plaintiffs and "others in [their] situation [should be relegated] to whatever remedy is created by state law."[2]

[2] The importance of obtaining judicial review is further demonstrated by the fact that Mallis should not be permitted to transform an unsuccessful state law fraud claim to a Federal claim

(footnote continued on following page)

Indeed if every case involving the pledge of securities would come within the Act, the Federal Courts would be burdened by a plethora of litigation involving the debtor and the bank when the loan goes bad and the debtor has pledged securities which are either sold or diminished in value as a result of shifts in the stock market.[3] If all loans collateralized by securities become subject to federal securities laws, it will render difficult the ability of borrowers to obtain credit from banks on the basis of their pledge of stock as collateral. Judicial review of so important a question as this is plainly warranted.

Professor Loss pointed out (1 Loss *ibid.* at 645) that the status of the foreclosure sales by pledgees "was unsettled by the Second Circuit decision of May, 1960 in the *Guild Films* case." Until then it had been generally considered that "a *bona fide* pledge [as here where it had taken place two years before] did not involve an 'offer' or 'sale' and that, in any event, a foreclosure sale by a *bona fide* pledgee

(footnote continued from preceding page)

under Rule 10b-5 merely by asserting a cause of action in Federal Court that has already been decided adversely to him in State Court. Section 10b of the Act does not concern itself with fraud per se as much as it is the effect of fraud upon investors and the public interest in free and open trading. The rights and remedies provided by the Securities Exchange Act are to serve "in addition to any and all other rights and remedies that may exist at law or in equity." Securities Exchange Act of 1934, Section 28(a), 15 USC Section 78bb. The decision adverse to Mallis by Justice Nadel in State Court is consistent with the Supreme Court of California in *Goodman* v. *Kennedy*, Security Law Reporter Section 95,829. In that case, the California Supreme Court held in a similar situation, as did Justice Nadel, that an attorney was not liable for failing to disclose facts which might indicate the possibility of such adverse consequences on sale of securities to the plaintiff's attorney in conversations discussing the proposed sale.

[3] See *Brodheim* v. *Chase Manhattan Bank*, 75 Misc. 2d 394, 347 N.Y.S.2d 394 (Sup. Ct. N.Y. 1973); *American Bank and Trust Company* v. *Lichtenstein*, 45 A.D.2d 790, 369 N.Y.S.2d 155 (1st Dept. 1975); *Smith* v. *Security National Bank*, 175 N.Y.L.J. p. 7, col. 1., and *Grace* v. *Sterling Grace & Co.*, 30 A.D.2d 61, 289 N.Y.S. 2d 632 (1st Dep't 1968).

of securities deposited as collateral • • • was exempt" under the law (Loss, *ibid.*). The Second Circuit decided an important question in the words of Professor Loss "with all its implications to the world of commercial banking" without considering the ramifications. 1 Loss *Ibid.* at 648. Loss noted soon after the Guild Films decision that as a result of the court's decision "the country's banks and their lawyers must guess whether another court • • • will limit *Guild Films* to its facts or whether the court's broad language will be taken as laying down the law with respect to pledges generally." Loss *Ibid.* at 649.

If this decision stands, the guesswork has now ended in the Second Circuit which held that any pledge of stock is subject to the Securities Act, whether or not the pledge was in connection with the allegedly fraudulent act. This decision is wrong and in plain conflict with the Fifth Circuit. Judicial review is required.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

JACK H. WEINER,
Attorney for Petitioner
1775 Broadway
New York, New York 10019

Of Counsel:

CHARLES LEEDS

March 31, 1977

Opinion of the Court of Appeals.

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

No. 26—September Term, 1976.

(Argued October 18, 1976 Decided January 3, 1977.)

Docket No. 76-7166

SAMUEL MALLIS and FRANKLYN KUPFERMAN,

Plaintiffs-Appellants,

v.

FEDERAL DEPOSIT INSURANCE CORPORATION, EUROPEAN-AMERICAN BANK & TRUST COMPANY, FRANKLIN NATIONAL BANK and BANKERS TRUST COMPANY,

Defendants-Appellees.

Before:

SMITH, OAKES and TIMBERS,

Circuit Judges.

Appeal from judgment entered in the Southern District of New York, Milton Pollack, *District Judge,* 407 F.Supp. 7, dismissing complaint for failure to state claims upon which relief can be granted and denying leave to amend complaint in action to recover damages and for other relief resulting from alleged violations of Regulation U of the Board of Governors of the Federal Reserve System and of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder.

Affirmed as to dismissal of Regulation U claim; as to dismissal of Securities Exchange Act claim, reversed and remanded with directions.

NOEL W. HAUSER, New York, N.Y. (Hauser & Rosenbaum, New York, N.Y., on the brief), *for Plaintiffs-Appellants.*

JACK H. WEINER, New York, N.Y. (Charles Leeds, New York, N.Y. on the brief), *for Defendant-Appellee Bankers Trust Company.*

PHILIP K. HOWARD, New York, N.Y. (John L. Warden, and Sullivan & Cromwell, New York, N.Y., on the brief), *for Defendant-Appellee European-American Bank & Trust Company.*

ROBERT S. ANDERSON, New York, N.Y. (Hughes Hubbard & Reed, New York, N.Y., on the brief), *for Defendant-Appellee Franklin National Bank.*

TIMBERS, *Circuit Judge:*

This appeal is from a judgment entered in the Southern District of New York, Milton Pollack, *District Judge*, 407 F.Supp. 7, dismissing the complaint for failure to state claims upon which relief can be granted and denying leave to amend the complaint in an action to recover damages and for other relief resulting from alleged violations of Regulation U of the Board of Governors of the Federal Reserve System, 12 C.F.R. § 221 (1976), and alleged violations of the antifraud provisions of the federal securities laws, including Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1970), and Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5 (1976).

The essential questions which we find presented and our rulings thereon are as follows:

(1) Whether a bank loan to appellants by Franklin National Bank was subject to Regulation U.
We hold that it was not.

(2) Whether appellants as pledgees of stock certificates of Equity National Industries, Inc. have standing to sue under Section 10(b) and Rule 10b-5.
We hold that they do.

For the reasons below, we affirm the dismissal of the Regulation U claim against European-American Bank & Trust Company and Franklin National Bank; but as to the dismissal of the Securities Exchange Act claim against the Bankers Trust Company, we reverse and remand with directions.

I. FACTS

Appellants Mallis and Kupferman are dentists.[1] Between March 1 and March 3, 1972 Jack J. Arnold, an attorney, persuaded them to make a short term loan of $156,000 to himself and his client, John B. Fowler, to finance the purchase of 40,034 shares of stock in Equity National Industries, Inc. (Equity National). The consideration to appellants was to be $50,000. In addition, appellants were to receive possession of the Equity National stock certificates as collateral. To fulfill their part of the

---

[1] We assume familiarity with the comprehensive statement of facts in the district court opinion. 407 F.Supp. at 9-10.

agreement, appellant immediately obtained a loan of $156,000 from appellee Franklin National Bank (Franklin National). The parties dispute whether this loan was to have been secured in turn by the Equity National certificates. This issue was not resolved by the district court.

Title to the Equity National shares desired by Arnold and Fowler was in Jerome and Judith Kates. But the certificates were in the possession of the Bankers Trust Company (Bankers Trust), to which the Kateses had pledged the shares as collateral for a loan. The Kateses still owed $45,000 on this loan on March 3, 1972.

The shares, which the Kateses had acquired pursuant to a merger between a corporation under their control and Equity National, were subject to an escrow agreement which required the return of the certificates to Equity National for cancellation or reissue depending on whether the acquired corporation met specified earnings conditions. Each certificate bore a legend which declared it to be subject to the escrow agreement and restricted transfer except in accordance with the terms of the agreement. Although other Equity National shares of the same series were registered under the Securities Act of 1933 and listed on the American Stock Exchange (Amex), the shares issued to the Kateses were not.

By a letter to Bankers Trust, Equity National had recalled the Kateses' shares for cancellation in March 1971. As a result the shares were worthless when the transactions here at issue occurred in March 1972.

A closing was held on March 3, 1972. Arnold and Fowler, the Kateses, and representatives of Franklin National and Bankers Trust were in attendance, but not appellants. Franklin National's representative delivered three checks totalling $156,000 to the Kateses. The Kateses endorsed one of the checks in amount of $45,000 to Bankers Trust. Bankers Trust then released the Equity National Certificates. The Kateses transferred the certificates to Arnold

and Fowler who subsequently delivered them to appellants in accordance with the loan agreement.

The instant action arises from the failure of Arnold and Fowler to repay their loan from appellants. In the district court appellants sought to assert two claims. First, they sought relief against Franklin National, now insolvent, and the European-American Bank & Trust Company (European-American), which purchased appellants' note along with Franklin National's other assets.[1] They sought rescission of their loan from Franklin National on the ground that the loan was made for the purpose of acquiring margin stock in an amount in excess of the maximum loan value of the stock in violation of Regulation U.[2] Second, they alleged that Bankers Trust violated the Securities Act of 1933 in disposing of the unregistered Equity National shares in the course of terminating their pledge agreement with the Kateses. During the course of proceedings in the district court appellants departed from this theory, which apparently looked to Section 12(1) of the 1933 Act, 15 U.S.C. § 771(1)(1970), and requested leave to amend their complaint to state a cause of action under Section 10(b) of the 1934 Act and Rule 10b-5 thereunder.

---

[1] The successors in interest to insolvent Franklin National are European-National and the Federal Deposit Insurance Corporation (FDIC).

As the receiver of Franklin National, FDIC was named in the complaint as a defendant with respect to appellants' Regulation U claim. Appellants since have stipulated to dismissal of their action against FDIC. Although Franklin National remains as a party, appellants no longer seek a money judgment against it.

[2] The complaint also alleged a pendant claim against Franklin National based on common law fraud. After dismissing appellants' federal claim against Franklin National, the district court dismissed the pendant claim for lack of subject matter jurisdiction and denied leave to amend it to assert a cause of action against Franklin National under the Securities Exchange Act. Appellants since have stipulated to the dismissal of both of these claims.

The theory underlying their claim against Bankers Trust is that it knowingly misrepresented that the certificates no longer were subject to the escrow agreement.

European-American, Franklin National and Bankers Trust moved to dismiss the complaint for failure to state claims upon which relief can be granted. The court granted the motions and dismissed the complaint in its entirety. In granting the motions of European-American and Franklin National to dismiss the Regulation U claim, the court held that Franklin National's loan was not made for the purpose of carrying or purchasing margin stock within the meaning of Regulation U. In granting the motion of Bankers Trust to dismiss, the court held that appellees, as pledgees, were not "purchasers" of securities and therefore could not state a claim under the 1933 Act. For the same reason the court denied leave to appellants to amend their complaint to allege a claim under Section 10(b) of the 1934 Act and Rule 10b-5.

From the judgment dismissing the complaint and the order denying leave to amend, this appeal has been taken.[4]

---

[4] Appellants' notice of appeal filed March 24, 1976 is "from the Order and Judgment of the HON. MILTON POLLACK".

Judge Pollack's opinion ordering dismissal of the complaint was filed September 30, 1975. On December 5, 1975, on motion of appellants' counsel, the judge filed a Rule 54(b) certificate directing the entry of a final judgment with respect to all defendants except FDIC so as to permit the instant appeal. We note that Judge Pollack's Rule 54(b) certificate complies with the approved practice in this Circuit that the required determination that there is no just reason for delay "ought not to be made as a matter of rote". *Arlinghaus* v. *Ritenour*, —— F.2d ——, —— (2 Cir. 1976), slip op. 239, 243 (October 26, 1976); *Gummer* v. *Shearson, Hammill & Co., Inc.*, 516 F.2d 283, 286 (2 Cir. 1974). Judge Pollack's finding that "[t]here is no just reason for leaving the claim against FDIC hanging in limbo and creating piecemeal appellate litigation" produced the additional therapeutic result of appellants' dismissal of their action against FDIC. See note 2, *supra*.

(footnote continued on following page)

The district court dismissed appellants' Regulation U claim for rescission against European-American and Franklin National on the ground that Regulation U does not apply to the loan in question. 407 F.Supp. at 10-11. We agree.

Regulation U prohibits banks from extending credit,

> "directly or indirectly . . . for the purpose of purchasing or carrying any margin stock in an amount exceeding the maximum loan value of the collateral. . . ." 12 C.F.R. § 221.1(a) (1976).[5]

The only definition of "margin stock" set forth in Regulation U which even approaches applicability to the instant shares is that of "a stock registered on a national securities exchange". 12 C.F.R. § 221.3(v) (1).[6] Although other shares

---

(footnote continued from preceding page)

However, since "[e]very good case requires a mystery document", *Westchester Fire Insurance Company* v. *Tantalo*, 273 F. Supp. 7, 12 n. 5 (D. Conn. 1967), it appears that the mystery document here is the judgment itself. Our search of the voluminous appendix and original district court record has failed to uncover any document that looks like a judgment. Since the parties and the district court have proceeded on the assumption that there was an adjudication of dismissal, we decline to stand on the technicality of the missing mystery document in this case.

[5] "Maximum loan values" are set forth in 12 C.F.R. § 221.4 (1976).

[6] 12 C.F.R. § 221.3(v) (1976) defines "margin stock" as:

> ". . . (1) a stock registered on a national securities exchange, (2) an OTC margin stock, (3) a debt security (i) convertible with or without consideration, presently or in the future, into a margin stock, or (ii) carrying any warrant or right to subscribe to or purchase, presently or in the future, a margin stock; (4) any such warrant or right, (5) any security issued by an investment company licensed under the Small Business Investment Company Act of 1958 . . . registered pursuant to section 8 of the Investment Company Act of 1940 . . . unless at least 95 percent of the assets of such company are continuously invested in exempted securities."

of the same series were listed on the Amex, the particular Equity National shares here in question were not listed on any national securities exchange. They therefore were not "margin stock" so as to trigger the application of Regulation U to the Bankers Trust loan.[1]

Moreover, appellants were neither "purchasing" nor "carrying" stock within the meaning of Regulation U. 12 C.F.R. § 221.1(a), *supra*. The Regulation specifically brings within its ambit credit extended to a bank customer engaged "principally, or as one of the customer's important activities, in the business of extending credit for the purpose of purchasing or carrying margin stocks. . . ." 12 C.F.R. § 221.3(g) (1976). Under the circumstances of this case, we construe this provision to state conditions which must be met before the Regulation will apply to an intermediate borrower who reloans the funds to enable another to purchase stock. Appellants, the intermediate borrowers here, had an independent interest in the transaction and bore an independent risk. We therefore need not decide whether we would construe § 221.3(g) otherwise if the intermediate loan were a sham entered into to circumvent the Regulation's application. Since borrowing for the purpose of relending to enable others to purchase or carry margin stock was not one of appellants' "important activities", we hold that Regulation U does not apply to the Franklin National loan.

Furthermore, European-American would be insulated from appellants' rescission claim even if Regulation U were applicable here. Section 29(c)(2) of the 1934 Act, 15 U.S.C. § 78cc(c)(2) (1970), bars construction of the Act or any regulation promulgated under it to afford a defense against "the collection of any debt . . . by any person who

[1] We agree with the district court's holding that the fact that other shares of the same series were listed on the Amex does not alter the result. 407 F.Supp. at 10-11.

shall have acquired [it] in good faith for value and without actual knowledge of the violation" of the Act or regulation. Regulation U was promulgated pursuant to Section 7 of the 1934 Act, 15 U.S.C. § 78g (1970). European-American's payment of value for appellants' obligation, its good faith, and its lack of actual knowledge of any underlying irregularity are not disputed. Accordingly, even if Regulation U were otherwise applicable, we hold that Section 29(c)(2) would bar appellants from asserting their rescission claim against European-American.

III. Securities Exchange Act Claim

This brings us to what we regard as the chief question in the case: whether appellants have standing to sue under Section 10(b) of the 1934 Act and Rule 10b-5. Specifically, the issue is whether under the definition of "sale" in Section 3(14) of the 1934 Act, 15 U.S.C. § 78c(14) (1970), a pledge fulfills the familiar requirement that the fraud occur "in connection with the purchase or sale" of a security.

In resolving the standing question against appellants, the district court relied on *McClure* v. *First National Bank of Lubbock*, 497 F.2d 490 (5 Cir. 1974), *cert. denied*, 420 U.S. 930 (1975). There the court acknowledged that a pledgor might be liable for fraud under Section 10(b) after his default and a consequent sale of the securities by the pledgee, but held that the pledge itself did not constitute a "sale". At the time of the decision below in the instant case, the district court did not have the benefit of our subsequent decision which rejected the rationale of *McClure* in a case arising under Section 17(a) of the 1933 Act. *United States* v. *Gentile*, 530 F.2d 461 (2 Cir.), *cert. denied*, —— U.S. —— (1976). We hold that *Gentile* and our earlier decision in *SEC* v. *Guild Films Co.*, 279 F.2d 485

(2 Cir.), *cert. denied*, 364 U.S. 819 (1960), control here and require that appellants be granted standing.

In *Guild Films* we held a pledge of stock to be a "sale" within the meaning of Section 2(3) of the 1933 Act, 15 U.S.C. § 77b(3) (1970),[8] in the context of determining that the pledgees there involved were "person[s] who [have] purchased from an issuer" within the meaning of the definition of "underwriter" in Section 2(11) of the 1933 Act, 15 U.S.C. § 77b(11) (1970). *SEC* v. *Guild Films Co., supra*, 279 F.2d at 489.[9] *Gentile* reaffirmed and expanded this holding. The defendant there was charged with a conspiracy to pledge fraudulently issued securities in violation of Section 17(a) of the 1933 Act, 15 U.S.C. § 77q(a) (1970). We again held a pledge to constitute a "sale" within Section 2(3), this time to satisfy the requirements of Section 17(a) that the fraud occur "in the offer or sale of any securities". *United States* v. *Gentile, supra*, 530 F.2d at 466-67. We held:

> "In effect, the pledgee assumes a very real investment risk that the pledged securities will have continuing value, a risk that is identical in nature to the risk taken by investors which serves as the indisputable basis for statutory regulation of securities transactions. We therefore find no reason to treat the equivalent risks differently under the statute." *Id.* at 467.[10]

---

[8] Section 2(3) defines a "sale" to include "every contract of sale or disposition of a security or interest in a security for value."

[9] We reasoned that the term "purchaser", "although not defined in the Act, should be interpreted in a manner complementary to 'sale'." *SEC* v. *Guild Films Co., supra*, 279 F.2d at 489.

[10] In rejecting the distinction drawn in *McClure* between the pledged shares while in the pledgee's possession and the same shares after a sale due to the pledgor's default, we stated:

> "We see no reason to make the character of the initial pledge dependent upon subsequent events." *United States* v. *Gentile, supra*, 530 F.2d at 467 n. 6.

The fact that *Gentile* was a criminal case in which civil standing was not an issue does not diminish its persuasion as a precedent with respect to the Section 10(b) claim before us. The existence of a "sale" is as essential to a criminal prosecution for violation of Section 17(a) as it is to a civil action under that section. We find no basis on the face of either the 1933 Act or the 1934 Act for denominating a pledge as a "sale" for criminal but not for civil purposes.

Nor would the standing policy enunciated by the Supreme Court in *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975), support such a conclusion. We recognize that the Court there expressed concern about vexatious suits by a potentially limitless class of plaintiffs. We further recognize that the granting of standing to pledgees creates potential plaintiffs where none might have existed. But a closer look at *Blue Chip* demonstrates that the specific concerns there expressed by the Court have no bearing on the question before us of granting standing to pledgees. The Court in *Blue Chip* had before it a plaintiff who claimed that the defendant's misrepresentations caused it to refrain from purchasing securities. The Court observed that the rule of *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2 Cir.), *cert. denied*, 343 U.S. 956 (1952), requiring a purchase or sale, had the virtue of excluding a class of plaintiffs who had not dealt in the security at all and whose cases as a result would stand or fall on oral testimony. Requiring that the plaintiff have "dealt in" the security would assure that each case stand upon at least one "objectively demonstrable fact." *Id.* at 746-47. A pledge which occurs pursuant to a loan contract is just as concrete a transaction as is a normal transfer of title.[11]

---

[11] Bankers Trust seeks to distinguish *Gentile* and *Guild Films* from the instant case on the further ground that neither of the pledges involved in those cases were bona fide. We fail to see

(footnote continued on following page)

Opinion of the Court of Appeals.

We believe that the rationale underlying our holding in *Gentile* with respect to Section 2(3) and 17(a) of the 1933 Act is persuasive authority for holding that a pledge constitutes a "contract to sell or otherwise dispose of" a security within the meaning of Section 3(14) of the 1934 Act. Accordingly, on the facts of this case, we hold that both a "sale" and a "purchase" may be cognizable under Section 10(b) of the 1934 Act. Appellants were purchasers by virtue of their acceptance of the pledge by Arnold and Fowler; and Bankers Trust was a seller by virtue of its release of the Kateses' pledge.

We therefore reverse the dismissal of appellants' Securities Exchange Act claim and remand the case to the district court with directions to grant leave to appellants to amend their complaint in accordance with this opinion. See *Rogers* v. *White Metal Rolling & Stamping Corp.*, 249 F.2d 262 (2 Cir. 1957), *cert. denied*, 356 U.S. 936 (1958).[12]

Affirmed as to the dismissal of the Regulation U claim against European-American and Franklin National; but as to the dismissal of the Securities Exchange Act claim against Bankers Trust, reversed and remanded with directions to grant leave to appellants to amend their complaint in accordance with this opinion.[13]

(*footnote continued from preceding page*)

what connection the pledgor's state of mind has with the question whether the pledgee has standing to sue. Such a distinction would be at odds with our rationale in *Gentile*.

[12] Bankers Trust also contends that the dismissal of an earlier common law fraud action brought against it and others by appellants in the New York state courts should have a collateral estoppel effect so as to bar appellants' claim under Section 10(b). This defense is a matter for trial which we do not reach now. But see *Herendeen* v. *Champion International Corp.*, 525 F.2d 130 (2 Cir. 1975).

[13] Having given due consideration to the motion by counsel for European-American for an award of attorneys' fees and double costs, we deny it.

Judgment of the Court of Appeals—United States Court of Appeals for the Second Circuit.

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the third day of January one thousand nine hundred and seventy-seven.

Present: Hon. J. Joseph Smith
Hon. James L. Oakes
Hon. William H. Timbers
Circuit Judges,

76-7166

Samuel Mallis and Franklin Kupferman,

Plaintiffs-Appellants,

v.

Federal Deposit Insurance Corporation, European-American Bank & Trust Company, Franklin National Bank and The Bankers Trust Company,

Defendants-Appellees.

Appeal from the United States District Court for the Southern District of New York.

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

On consideration whereof, it is now hereby ordered, adjudged and decreed that the order and judgment of said

Judgment of the Court of Appeals—United States Court of Appeals for the Second Circuit.

District Court be and they hereby are affirmed in part and reversed in part and that the action be and it hereby is remanded to said District Court for further proceedings in accordance with the opinion of this court with costs to be taxed aaginst the plaintiffs-appellants in favor of defendant-appellee European American Bank & Trust Company and against defendant-appellee Bankers Trust Company in favor of plaintiffs-appellants.

A. Daniel Fusaro
Clerk

by Arthur Heller
Deputy Clerk

Decision of the District Court.

UNITED STATES DISTRICT COURT
Southern District of New York

75 Civ. 909 (MP)

Memorandum

#43153

Samuel Mallis and Franklyn Kupferman,

Plaintiffs,

v.

Federal Deposit Insurance Corporation, European-American Bank & Trust Company, Franklin National Bank and The Bankers Trust Company,

Defendants.

Appearances:

Hauser & Rosenbaum
Attorneys for Plaintiffs
350 Fifth Avenue
New York, N.Y. 10001
By: Noel W. Hauser, Esq.

Hughes Hubbard & Reed
Attorneys for Defendant (Federal Deposit Insurance Corporation as Receiver of Franklin National Bank)
One Wall Street
New York, N.Y.
By: Robert S. Anderson, Esq.

SULLIVAN & CROMWELL
Attorneys for Defendant (European-American Bank & Trust Company)
48 Wall Street
New York, N.Y.
By: John L. Warden, Esq.

Charles Leeds, Esq.
Attorney for Defendant (Bankers Trust Company)
1775 Broadway, New York, N.Y. 10019
By: Nathan Silverman, Esq.

MILTON POLLACK, District Judge.

Federal Deposit Insurance Corporation (FDIC hereafter) and European American Bank (EA) are successors in interest to an insolvent, Franklin National Bank (FNB).

Plaintiffs, two dentists, borrowed $156,000 from FNB on March 3, 1972, and now claim that the loan (reduced substantially by repayments on account) violated Regulation U (Federal Reserve Regulations 12 CFR Section 221.1 et seq.) prohibiting loans secured by margin stock in an amount in excess of the prescribed maximum loan value of the stock. Plaintiffs contend in their first claim for relief that the loan was made for the purposes of carrying or acquiring margin stock and is therefore void and that it should be declared that they are not liable thereon.

Since the loan was neither directly nor indirectly made for the purpose of carrying or purchasing "margin stock" or being secured thereby nor were the arrangements with plaintiffs interposed as a subterfuge for avoidance of Regulation U by FNB, the first claim fails to state a claim on which federal relief may be granted.

Plaintiffs, Mallis and Kupferman, arranged the loan from FNB based solely on their signatures to a loan agreement. Their purpose was to take advantage of a business opportunity which they hoped would yield them a $50,000 profit. The opportunity involved the loan by them of money to one Fowler and his attorney Arnold on the obligation to repay the same on certain conditions with a $50,000 bonus or profit for the accommodation. Fowler had made a deposit toward the purchase of 40,000 shares of Equity National Industries, Inc., and needed more funds in order to complete the purchase. The shares were held by Bankers Trust Company, a defendant herein, as collateral for a loan to the shares' owners, Jerome and Judith Kates, who were the sellers in the transaction with Fowler.

The shares were unregistered, but Arnold is alleged to have represented to Mallis that they would become marketable in the near future because of a new rule promulgated by the Securities Exchange Commission. The shares if marketable would have, according to plaintiffs, been worth at least $400,000.

In actuality, the shares were subject to a restriction that ultimately made them worthless. They had been issued to the Kates pursuant to the agreement by which a company called Take-Two, Inc. was merged into a subsidiary of Equity. The two certificates for the shares bore legends indicating that the shares had not been registered under the Securities Act and could not be transferred except in accordance with an escrow agreement to which they were subject. Under the escrow agreement, depending on whether specified earnings conditions for the prior business of Take-Two were met for specified years, the shares would be returned to Equity to be either cancelled or reissued without the restrictive legend referring to the escrow agreement.

By letter of March 1, 1971, Equity wrote to Bankers Trust, which held the shares as collateral on an August 1970 loan to the Kates, indicating that the earnings requirement had not been met for 1970 and requesting that the Equity shares issued to the Kates be delivered to

Equity in accordance with the escrow agreement. Bankers Trust declined to do so. Equity brought suit in New York to obtain a cancellation of the shares but the suit did not proceed to a judicial determination. Equity ultimately brought suit in Delaware state court in May 1974 to obtain or to void the certificates of stock, naming the plaintiffs, the Kates, and FNB as defendants, but not Bankers Trust. This suit also did not go to judgment. Plaintiffs allege that the shares are now worthless, and indeed were worthless at the time of the Mallis-Arnold-Kates agreement culminating in their sale. At the closing of the sale, the funds transferred to Kates as consideration for the stock were turned over to Bankers Trust in payment of the outstanding indebtedness of the Kates to Bankers Trust. Bankers Trust then released the stock. Plaintiffs took the shares as collateral for their loan to Arnold and Fowler and now hold them after default by those borrowers.

Plaintiffs, as noted *supra*, seek to cancel their own indebtedness to FNB and its successors by alleging that the loan to them was in violation of Regulation U of the Board of Governors of the Federal Reserve System, 12 C.F.R. § 221.1 *et seq.*, as having been secured by stock for the purpose of purchasing or carrying "margin stock" in an amount in excess of the prescribed maximum loan value of the collateral.

Plaintiffs' allegations on this point fall short of adequacy in at least two ways, even assuming *arguendo* that they have sufficiently alleged that the loans were secured by stock. *Cf. Freeman* v. *Marine Midland Bank-New York*, 494 F.2d 1334 (2d Cir. 1974). The shares in question here were not "margin stock" within the meaning of Regulation U, and there was no loan for the purpose of purchasing stock within the meaning of that regulation.

The only definitional category of margin stock which arguably applies to the certificates of Equity common stock

involved herein is that of stock "registered on a national securities exchange". It appears that listed shares of Equity common stock were in fact registered and traded on an exchange at the time of the transaction herein. However those shares here involved were neither registered nor listed on a national securities exchange.

EA and FDIC have introduced the listing application submitted to the American Stock Exchange by Equity for the listing of a number of categories of common stock including "175,000 additional shares of its common stock, *upon official notice of issuance*, which represent the maximum number of shares which the Company may be obligated to issue to the former shareholders of Take-Two, Inc. . . . if the earnings of the business formerly conducted by such company reach certain specified levels." (emphasis added) (Exhibit A to Howard affidavit, May 16, 1975).

In order for such shares to have been actually listed, Equity would have had to formally notify the Exchange that the conditions had been met, a "registration authorization" indicating the number of shares would have had to be prepared by the Exchange, and a listing fee would have had to be paid by Equity. A review of the American Stock Exchange file indicated that none of these steps had ever been taken, and that the shares were never listed, which is hardly surprising given Equity's efforts to have the shares returned to it. (*See* Howard affidavit, *supra*, ¶¶ 3 and 4).

Contrary to plaintiffs' assertions, shares of stock are not "registered" on a securities exchange within the meaning of Regulation U when they are not themselves listed merely because other shares of their class are listed. *See* Published Interpretations of the Board of Governors of the Federal Reserve System, ¶ 6440 (1971) (Regulation U not applicable to loan to purchase newly issued stock during initial over the counter trading period prior to the stock "becoming registered (listed) on a national securities

exchange"). The opinion letter of an attorney for the Board of Governors submitted to this Court by the plaintiffs is not dispositive here since the question the attorney was answering is not on point with the issue in contention. Since the Equity shares purchased from the Kates were not registered on a national securities exchange and fit into no other category set out in Regulation U, they were not "margin stock" within that regulation's meaning.

Regulation U bars a grant of credit directly or indirectly secured by any stock for the *purchase* or carrying of margin stock. EA and FDIC argue that the only situation in which Regulation U applies to loans made to a borrower who in turn relends the funds to a third person for the purchase of stock is if the initial borrower is engaged principally or as one of his important activities in the business of extending credit for the purpose of purchasing margin stock. *See* 12 C.F.R. § 221.3(q). They argue that if Regulation U applied to every loan of the type in this case, 12 C.F.R. § 221.3(q) would be superfluous.

It may well be that Regulation U would nevertheless be applicable if the initial borrower were simply interposed as a subterfuge for a bank's avoiding the regulation but that is plainly not the situation here. Plaintiffs were clearly more than nominal intermediaries between FNB and Arnold in light of their own prospective profit. Thus, it cannot be fairly argued that the loan by FNB to the plaintiffs was made for the purpose of purchasing stock within the meaning of Regulation U, even though the funds were ultimately used by Arnold to purchase stock.

As a second claim for relief, plaintiffs allege a pendent claim against FNB based on allegations of common law fraud consisting of alleged misrepresentations of an officer of FNB to the effect that he had reviewed the transaction and that it was regular in all respects. Since there is no federal basis for this suit, there being no Regulation U claim, there is no basis for pendent jurisdiction and the

second claim must therefore be dismissed. Leave to amend to assert this claim under Rule 10b-5 of the Rules and Regulations promulgated pursuant to Section 10b of the Securities and Exchange Act of 1934, as amended, will be denied as unavailing to plaintiffs who were not purchasers within the requirement of the *Birnbaum* doctrine, *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952), as adopted in *Blue Chip Stamps* v. *Manor Drug Stores*, 43 U.S.L.W. 4707 (June 9, 1975), —— U.S. —— (1975).

The mere acceptance of a stock pledge as collateral in a privately negotiated transaction between borrower and lender does not of itself bring a transaction within the scope of the federal securities laws. *See, e.g., McClure* v. *First National Bank of Lubbock, Texas*, 497 F.2d 490 (5th Cir. 1974), *cert. denied* 43 U.S.L.W. 3449 (1975); *Rosen* v. *Dick*, [1974-75] CCH Fed. Sec. L. Rep. ¶ 94,786 (S.D.N.Y. Sept. 3, 1974). Thus, even if the FNB loan to Mallis and Kupferman were secured by a pledge of the Equity stock, which is disputed by EA and FDIC, plaintiffs could still not state a claim entitling relief under Rule 10b-5 on that basis since no purchase or sale was involved.

Similarly, there was no purchase by plaintiffs in this case. Plaintiffs loaned the funds to Arnold and Fowler, who had already contracted to buy the stock in question. While the stock later came into plaintiffs' possession as collateral for their loan, the consideration for that loan was the obligation by Arnold and Fowler to repay with a bonus. Attempts to characterize the transaction as a purchase of the stock by plaintiffs are not convincing. To allow persons in plaintiffs' situation to sue under Rule 10b-5 would be to expand the class of prospective litigants under that rule to an extent uncalled for by the words of the rule or the statute. *Cf. Bolger* v. *Laventhol, Krekstein, Horwath & Horwath*, 381 F. Supp. 260, 267 (S.D.N.Y. 1974).

The third claim seeks relief only against Bankers Trust Company for orally asserting that the stock certificates were no longer subject to the restrictive legend thereon tieing them to an escrow agreement while allegedly having knowledge that the certificates were void.

While this third claim is predicated on fraud under the Securities Act of 1933, as amended, no federal claim is asserted on which relief may be granted since plaintiffs were not "purchasers" of the securities. For the same reason, plaintiffs' offer to amend their complaint to assert a claim under § 10 of the Securities Exchange Act based on this allegation would be unavailing; permission to so amend is denied.

With respect to their offer to amend this third claim, plaintiffs claim that strict adherence to the *Birnbaum* purchaser-seller requirement for 10b-5 suits is no longer mandated in light of the holding in *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6 (1971). This claim is unpersuasive in light of the fact that the plaintiff in *Bankers Life* (the liquidator of Manhattan Casualty Co.) was clearly within the scope of the *Birnbaum* rule. *See Haberman* v. *Murchison*, 468 F.2d 1305, 1311 n.5 (2d Cir. 1972).

In *Bankers Life* the Supreme Court recognized that creditors of a corporation in the process of being liquidated have an interest in a suit brought by the liquidator, but the Court carefully added that

> . . . the fact that creditors of the defrauded corporate buyer or seller may be the ultimate victim does not warrant disregard of the corporate entity . . . The crux of the present case is that *Manhattan* [the corporate seller] suffered an injury as a result of deceptive practices touching *its* sale of securities as an investor. *Bankers Life, supra*, at 12-13 (emphasis added)

Opinions in the Second Circuit since *Bankers Life* have reaffirmed the vitality of the *Birnbaum* purchaser-seller doctrine except in a few narrow and irrelevant categories of cases. *Haberman, supra; International Controls Corp.* v. *Vesco*, 490 F.2d 1334, 1343, 1346 n.16 (2d Cir. 1974); *Petersen* v. *Federated Development Co.*, 387 F. Supp. 355, 358 (S.D.N.Y. 1974); *Gurvitz* v. *Bregman*, 379 F. Supp. 1283, 1286 (S.D.N.Y. 1974); *Davidge* v. *White*, 377 F. Supp. 1084, 1087 (S.D.N.Y. 1974); *Goodall* v. *Columbia Ventures, Inc.*, 374 F. Supp. 1324, 1329 (S.D.N.Y. 1974).

Leave to join Arnold and Fowler as involuntary parties pursuant to Rule 19 of the Federal Rules of Civil Procedure is also denied.

Rule 19(a) provides that

> [a] Persons to be Joined if Feasible. A person who is subject to service of process and whose joinder will not deprive the court of jurisdiction over the subject matter of the action shall be joined as a party in the action if (1) in his absence complete relief cannot be accorded among those already parties, or (2) he claims an interest relating to the subject of the action and is so situated that the disposition of the action in his absence may (i) as a practical matter impair or impede his ability to protect that interest or (ii) leave any of the persons already parties subject to a substantial risk of incurring double, multiple, or otherwise inconsistent obligations by reason of his claimed interest. . . .

None of the requirements of this Rule are satisfied by plaintiffs' request. In the absence of Arnold and Fowler "complete relief" can be "accorded among those already parties." Dismissal of this action would in no way "impair or impede" the ability of Arnold and Fowler to "protect their interests," nor would it "leave any of the persons already parties subject to a substantial risk of in-

curring double, multiple, or otherwise inconsistent obligations by reason of his claimed interest."

The general rule is that if the merits may be determined without prejudice to the absent party, the Court "will strain hard to reach that result." *Bourdieu* v. *Pacific Oil Co.*, 299 U.S. 65, 70 (1936); *Charron* v. *Meaux*, 60 F.R.D. 619, 622 (S.D.N.Y. 1973).

FDIC has joined in the motion to dismiss submitted by EA and FDIC and EA have submitted a joint brief setting forth their discussion on the viability of the complaint. The positons of those two defendants are identical on these issues. The motion is granted. The first claim is dismissed for failure to state a federal claim upon which relief can be granted. The second claim is a common law claim pendent for jurisdiction on the first claim and is consequently dismissed for lack of subject matter jurisdiction over it.

Bankers Trust submitted two affidavits to the Court urging dismissal of the third claim in the complaint which is asserted against it alone. The plaintiffs have presented their legal arguments on this point and have responded to the Bankers Trust affidavits. That motion is granted. The third claim for relief, the only one directed towards Bankers Trust, is dismissed for failure to state a claim upon which relief can be granted and for lack of jurisdiction over the subject matter of the controversy attempted to be raised therein.

It appears that FNB is an insolvent, whose interests in this case have passed to FDIC and/or EA, and it thus seems appropriate to terminate this litigation in this Court by dismissing the claims as to FNB as well.

Complaint dismissed in its entirety.

So Ordered.

September 30, 1975

Milton Pollack
U.S. District Judge

Addendum to Memorandum Opinion of Pollack, D.J., Dated October 2, 1975.

UNITED STATES DISTRICT COURT
Southern District of New York

75 Civ. 909 (MP)

Memorandum

Samue Mallis and Franklyn Kupferman,

Plaintiffs,

v.

Federal Deposit Insurance Corporation, European-American Bank & Trust Company, Franklin National Bank and The Bankers Trust Company,

Defendants.

Appearances:

Hauser & Rosenbaum
Attorneys for Plaintiffs
350 Fifth Avenue
New York, N.Y. 10001
By: Noel W. Hauser, Esq.

Hughes Hubbard & Reed
Attorneys for Defendant (Federal Deposit Insurance Corporation as Receiver of Franklin National Bank)
One Wall Street
New York, N.Y.
By: Robert S. Anderson, Esq.

Addendum to Memorandum Opinion of Pollack, D.J., Dated October 2, 1975.

SULLIVAN & CROMWELL
Attorneys for Defendant (European-American Bank & Trust Company)
48 Wall Street
New York, N.Y.
By: John L. Warden, Esq.

CHARLES LEEDS, Esq.
Attorney for Defendant (Bankers Trust Company)
1775 Broadway, New York, N.Y. 10019
By: Nathan Silverman, Esq.

MILTON POLLACK, District Judge

Since the filing of the decision in this case, defendant Federal Deposit Insurance Corporation has called the Court's attention to 12 U.S.C. § 1819 (1970), which authorizes suit against this defendant in the federal courts on a state law claim.

Accordingly, the dismissal of Count 2 against this defendant is set aside and liability or any other matter pertaining to that claim alone may be reargued. Counsel should submit briefs accordingly within 10 days hereof.

SO ORDERED.

October 2, 1975

MILTON POLLACK
U.S. District Judge

Decision—Opinion of New York Supreme Court.

OPINION OF NADEL, J.

SUPREME COURT : NEW YORK COUNTY
INDIVIDUAL CALENDAR PART 8

Index No. 25831/72

SAMUEL MALLIS,

Plaintiff,

—against—

JEROME B. KATES, JUDITH KATES, JACK J. ARNOLD, JOHN B. FOWLER, JR., EQUITY NATIONAL INDUSTRIES INC., EQUITY-TAKE TWO, INC., THE NATIONAL BANK OF GEORGIA, BANKERS TRUST COMPANY and WILLIAM LONDON,

Defendants.

NADEL, J.:

The three separate motions for dismissal of the complaint brought at various times by defendants, Equity National Industries, Bankers Trust Company and William London are consolidated for the purpose of this disposition.

Plaintiff, a dentist, entered into an arrangement with his own lawyer, defendant Arnold, whereby he advanced the sum of $156,728 for one month, and was to receive a "profit" of $50,000.00. As collateral for this loan, plaintiff was to hold 40,384 shares of Equity National Industries, Inc. There is absolutely nothing in the letter from defendant Arnold and defendant Fowler, whose status in this transaction is otherwise undefined, to indicate from whom the Equity shares would be obtained. Plaintiff received $50,000.00. He did not even attend the closing where his funds were transmitted by an officer of Franklin National Bank.

The Equity shares were restricted. The two stock certificates bore a legend to that effect on their face, and on the reverse side spelled out an Escrow Agreement held by the National Bank of Georgia. Arnold asked for and received an affidavit from defendant Kates to the effect that the restrictive legend had no force and effect. The shares were held by defendant Bankers Trust Company as collateral for a loan it had made to defendant Kates. The closing took place at Bankers Trust. Plaintiff thereafter found the stock to be without value and brought this action in conspiracy and fraud against all parties having any connection whatever with the shares or the transaction.

Defendant London, who was Kates' counsel, drafted an agreement between Kates and Arnold, and had no knowledge as to the existence of plaintiff. Moreover, he did not attend the closing. Plaintiff alleges he was guilty of silence when he had a duty to speak, which amounted to a "fraudulent concealment" because he knew of the Escrow Agreement and did not inform plaintiff.

Bankers Trust is likewise charged with the same duty to speak for the protection of plaintiff Equity National Industries, Inc., and is charged with both fraud and negligence in permitting "escrowed stock" into the possession of defendant Kates, thereby allegedly aiding and abetting in the swindle.

Plaintiff is proceeding under several fallacies with respect to facts. The Escrow Agreement sets up two classes of shares, conditional shares which were issued to the stockholders of the company being acquired subject to recall if certain profits were not realized, and final shares, which were held by the escrow agent until the number of final shares to be exchanged for conditional shares could be determined. The conditional shares had a restrictive legend placed on both face and back of each certificate. The restriction did not per se make the stock "worthless"

as plaintiff contends. Equity National did not allow "escrowed shares" to circulate. These were final shares under the terms of the Escrow Agreement, which plaintiff could have determined from the National Bank of Georgia, the escrow agent, as well as transfer agent, if he had taken the precaution of examining the stock certificates.

The leading case on where there is a duty to speak is *Amend* v. *Hurley,* 293 N.Y. 587, which holds that barring a fiduciary or confidential relationship there is no duty to speak. Plaintiff had absolutely *no* relationship with defendants London, Bankers Trust or Equity National. He was not even a purchaser of the shares, according to his letter arrangement with Arnold. No matter what he chooses to call his participation in this "investment", the Equity shares are called "collateral" and he is guaranteed *repayment* out of another stock transaction.

The "fraudulent concealment" he alleges against these defendants must fall on the basis of plaintiff's own exhibits in opposition to these motions. The legend showing a restriction on the sale or hypothecation of the shares appears on the face and back of both stock certificates. The court is unable to determine when or how plaintiff could or should have been informed by these defendants, who could not and did not know of his existence prior to the closing which he did not attend.

The motions to dismiss by these three defendants are granted. Settle orders.

s/ J. NADEL
J.S.C.

Dated: July 13, 1972